file & Sourced
Cys

DATE 10/11/85

DOC NO NESA M85-10205

OCR CYS 3

P&PD CY 1

Sanitized Copy Approved for Release 2010/01/22 : CIA-RDP85T01058R000507000001-4

[redacted] 25X1

700

SUBJECT: Israel and Austerity: An Overview

NESA M#85-10205

DISTRIBUTION

EXTERNAL

1 - The Honorable Caspar W. Weinberger (Pentagon)
1 - Lt. Col. Fred Hof (ISA)
1 - The Honorable Richard L. Armitage (Pentagon)
1 - Jock Covey (NSC)
1 - George S. Harris (State)
1 - Philip Wilcox (State)
1 - David Mack (State)
1 - Howard Teicher (NSC)

INTERNAL

1 - DDI
1 - NIO/NESA
1 - C/PES
1 - DDO/NE [redacted] 25X1
1 - PDB Staff
4 - CPAS/IMD/CB
1 - D/NESA
1 - DD/NESA
1 - C/NESA/PPS
2 - NESA/PPS
1 - NESA/AI
2 - NESA/AI/I

DDI/NESA/AI/I [redacted] (10Oct85) 25X1

[redacted] 25X1

Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

10 October 1985

ISRAEL AND AUSTERITY: AN OVERVIEW

Summary

To tackle Israel's massive economic problems, the National Unity government proposed substantial budget cuts, devaluation of the shekel, and a wage-price accord upon entering office in September 1984. After intense negotiations with labor, the government announced the first package deal in November, but it frittered away the opportunities to implement fully this and subsequent accords. The unity government has made a serious effort at economic reform only since its announcement on 1 July of a new series of austerity measures. This program calls for cuts in real government expenditures, along with reduced public-sector employment and a new wage-price accord. While public reaction was sharply critical at first, Israelis now appear to have accepted the need for fiscal austerity. To make the new plan work, the government must enforce the entire range of restrictive policies called for in its July program plus additional measures including major tax and wage indexation reforms. [redacted] 25X1

* * * * *

The formation of the National Unity government in September 1984 was meant in part to assure bipartisan support for tackling Israel's economic morass. Seven years of Likud rule had left Israel with soaring triple-digit inflation and widening external deficits. The new unity government was thought by many in Israel to possess the political clout to push through a long

---

This memorandum was prepared by [redacted] the Israel-Jordan-Palestinian Branch, Arab-Israeli Division, Office of Near Eastern and South Asian Analysis. Information as of 10 October 1985 was used in its preparation. Questions and comments should be directed to Chief, Arab-Israeli Division, [redacted] 25X1

NESA M#85-10205

CONFIDENTIAL [redacted] 25X1

[redacted] 25X1

overdue austerity program. Moreover, Israeli consumers were psychologically prepared for such a move. [redacted] 25X1

The government acted quickly by proposing substantial budget cuts, shekel devaluation, and higher energy prices. The next step was to seek a wage-price accord to cool inflationary expectations and give the government time to develop a more comprehensive economic program. After weeks of squabbling within the coalition and the Histadrut labor federation, Prime Minister Peres personally intervened to secure the first package deal in November. [redacted] 25X1

Ineffective Package Plans

The government failed, however, to use the breathing space provided by this accord--as well as the early provision of US economic aid--to implement a more lasting stabilization program. Moreover, it encountered great difficulty in executing the budget cuts initially agreed upon. The few cuts that actually occurred were soon negated by revenue shortfalls and rising expenditures on subsidies. [redacted] 25X1

The coalition frittered away the last month of Package Deal 1 in January seeking minor, politically palatable ways to correct its deficiencies. Two subsequent package deals and additional ad hoc measures--tax hikes, higher travel fees, import restrictions, and the like--were merely cut-and-paste attempts to close the budget deficit, halt foreign exchange losses, and generate renewed public confidence. [redacted] 25X1

One opportunity for action--the 1985/1986 budget commencing 1 April--was also wasted. The $23.3 billion budget agreed to was, in fact, higher than the 1984 budget. This budget aims to reduce the deficit largely by continuing subsidy cuts--eliminating most of last year's overspending--by increasing fees and taxes, and only partly by reducing other expenditures. [redacted] 25X1

With the collapse of the latest package deal this spring--largely because the government lacked the political will to enforce all the provisions of the accord--the coalition approved a new plan on 1 July. It calls for reductions in government spending, additional taxes, reduced public-sector employment in selected ministries, devaluation of the shekel, and price increases to correct for subsidy reductions that will be followed by a three-month wage-price freeze. [redacted] 25X1

Reaction to the new austerity program predictably was sharply critical. The Histadrut argued that the plan would harm workers and threatened a national strike as a show of force against the plan. The threatened one day national strike was averted after Prime Minister Peres intervened to smooth strained relations between Finance Minister Modai and labor leaders. [redacted] 25X1

[redacted] 25X1

Outlook

The Israeli economy is beginning to respond to the government's latest austerity measures, but so far the private sector has made most of the sacrifices. The government has dragged its feet in dismissing public sector employees and has been unable to hold the line on expenditures, despite projected cuts. Unemployment is rising, even though the dismissals planned for the public sector have yet to occur. [redacted] 25X1

Israelis seem to have accepted the need for fiscal austerity despite its unpleasant impact; recent polls suggest that nearly two-thirds of the public support the government's program, and labor actions have virtually ceased since earlier disruptions that occurred periodically last spring. Even the announcement of an inflation rate of 27.5 percent in July--representing the highest monthly increase in Israel's history--resulted in little more than grumbling. The August inflation of 3.9 percent has further quieted public concern. [redacted] 25X1

Broad public support for current policies could wane, however, if workers perceive that they are once again bearing the brunt of austerity. To deal effectively with triple-digit inflation, the government must enforce the entire range of restrictive policies outlined in its July program plus additional measures, including further reductions in real government expenditures, tax reforms to boost worker incentives, and indexation reforms--especially of financial assets--to reverse the downward trend in labor productivity and investment. The recent infusion of additional US economic aid gives Israel breathing space to enact these measures. [redacted] 25X1

In the past, the unity government has lacked the political courage to move decisively to enforce agreed provisions of the various austerity plans. We judge that the coalition is more determined now to implement tougher austerity measures, but will remain unwilling to move quickly to impose the full range of reforms. Prime Minister Peres is particularly likely to act with caution on the economy as he nears the end of his tenure next fall, when he is obliged by the coalition agreement to turn over the prime ministership to Likud leader Shamir. [redacted] 25X1

[redacted] 25X1

Appendix

Israel: Inflation and Indexation

The National Unity Government's campaign to curb Israel's triple-digit inflation has focused on reforming the wage indexation system. Indexation is not the sole problem, however, and the government must enforce all aspects of its current austerity program, including reductions in real government expenditures. [redacted] 25X1

The Inflationary Spiral

Israeli inflation has grown dramatically over the past decade, climbing from low two-digit levels in the early 1970s to an annual inflation rate of 445 percent in 1984. The unity government's stop-gap measures have helped, but inflation still is running at about 275 percent on an annual basis after the first nine months of this year. [redacted] 25X1

The growing inflation during the past decade was due in part to a series of external shocks, especially the large increases in OPEC oil prices in 1973, 1974 and 1979. The first oil price shock alone increased Israel's oil import costs by an amount exceeding 3 percent of its gross national product. The second oil price hike in 1979 proved even more damaging because it was accompanied by the return to Egypt of the Sinai oil fields. [redacted] 25X1

Excessive demand, fueled by government spending, has also been a major factor. Starting in 1977, Likud-led governments resorted to an expansionary fiscal policy to curry favor with Israeli consumers, while pursuing such costly projects as the expansion of settlements on the West Bank and the invasion of Lebanon. Such moves resulted in large annual budget deficits financed by either borrowing in the private sector or by printing money. Furthermore, Likud's exchange rate policies designed to reduce the trade deficit boosted import prices, adding to the upward spiral of domestic prices. [redacted] 25X1

The financial liberalization introduced by the Likud Party at the end of 1977 added further impetus to inflation because the lifting of capital controls allowed Israelis to hold both foreign currency and foreign bank accounts. PATAM accounts--dollar-linked shekel accounts--created at this time have been used extensively since as transaction accounts by Israelis, allowing for further growth in the money supply. [redacted] 25X1

The Indexation Link

Indexation of wages to the consumer price index has been an important--but not predominant--factor in the inflationary process. The initial justification for implementing an economy-wide system of indexation was founded on traditional,

egalitarian beliefs in Israeli society. Indexation was promoted as a mechanism to help ensure social justice. More recently, it has been viewed as a necessity to protect Israelis from the ravages of triple-digit inflation. In the process, indexation has expanded into virtually every aspect of the Israeli economy. [redacted] 25X1

-- The current wage agreement--temporarily suspended by wage-price accords--indexes wages at 80 to 90 percent of the previous month's increase in the consumer price index.

-- Pensions and welfare payments are fully linked to the CPI.

-- Most financial assets--such as long-term savings accounts or government-issued bonds--are partially or fully linked to the CPI or some foreign currency.

-- Taxes are fully linked to the CPI and adjusted on a quarterly basis. [redacted] 25X1

The Costs of Indexation

Wage indexation--as extensive as it is--would not by itself completely protect Israeli workers from inflation. With indexation at less than 100 percent and applied with a one-month lag, real wages theoretically would fall with no additional adjustments and thus dampen demand. But indexation coupled with normal promotions and the high level of success enjoyed by most labor unions in securing additional wage boosts, has contributed to positive real wage growth. Real wage growth averaged 5.3 percent during the Likud years from 1977-1983 and was close to one percent last year despite a sharp economic slowdown. [redacted] 25X1

Such wage growth has discouraged the serious social disruption typical of countries with triple-digit inflation. Work actions are common, but usually are mounted to press the government to adopt tougher anti-inflationary policies, not for higher wages. Because indexation has taken much of the sting out of inflation, moreover, successive Israeli governments have only resorted to bandaid measures that have not realistically addressed other pressing issues, such as reforms in monetary policy and curbs on government spending. [redacted] 25X1

An additional problem is that high wage growth has not been matched by labor productivity growth, ensuring that aggregate demand continues to outstrip supplies. Labor productivity grew by just 1.6 percent per year between 1977 and 1981 and has steadily dropped the past three years. Some of the main factors contributing to this decline include:

-- The hesitancy of employers to lay off workers for fear of being caught short when demand strengthens.

-- High marginal tax rates that have reduced workers' incentives.

-- The use of substantial blocks of work time to juggle assets and make purchases to hedge against triple-digit inflation. [redacted] 25X1

Indexation also has contributed to resource misallocations with investment a major casualty. With most financial assets linked, Israelis have been unwilling to risk investing money in capital goods with uncertain real rates of return. Real investment fell over 9 percent last year and is projected to drop 10-15 percent this year, contributing to the recent poor productivity performances. [redacted] 25X1

Recent Indexation Adjustments

Since the first wage-price package deal in November 1984, the unity government has reached several agreements with the Histadrut labor federation to revise the cost-of-living-adjustment (COLA) formula. For a brief period the indexation formula was reduced by one-third, but more recently the COLA's have been suspended outright. The government's agreement to grant supplemental lump-sum wage payments has helped offset these losses. Nonetheless, real wage growth during the first nine months of the coalition government was less than it would have been without the revisions, and the sharp cuts in real wages since the imposition of the austerity program in July have lowered wages to the level of about four years ago. [redacted] 25X1

The National Unity Government is continuing its pressure to lower wages, according to US Embassy sources. The government recently gained Histadrut's agreement in principle to forego special wage adjustments--other than those provided for last July--until 1 April 1986, when the current public sector wage agreement expires. [redacted] 25X1

[redacted] 25X1

SUBJECT: Israel and Austerity: An Overview

Sourced Copy

NESA M#85-10205

DISTRIBUTION

EXTERNAL

1 - The Honorable Caspar W. Weinberger (Pentagon)
1 - Lt. Col. Fred Hof (ISA)
1 - The Honorable Richard L. Armitage (Pentagon)
1 - Jock Covey (NSC)
1 - George S. Harris (State)
1 - Philip Wilcox (State)
1 - David Mack (State)
1 - Howard Teicher (NSC)

INTERNAL

1 - DDI
1 - NIO/NESA
1 - C/PES
1 - DDO/NE [redacted] 25X1
1 - PDB Staff
4 - CPAS/IMD/CB
1 - D/NESA
1 - DD/NESA
1 - C/NESA/PPS
2 - NESA/PPS
1 - NESA/AI
2 - NESA/AI/I

DDI/NESA/AI/I [redacted] (10Oct85) 25X1